Ontario

FINAL REPORT, PART I

REFINING AND MARKETING
IN ONTARIO.

the Royal Commission on Petroleum Products Pricing

June 1976

TO HER HONOUR THE LIEUTENANT GOVERNOR:

May it please your Honour, I, the Commissioner appointed on August 1st, 1975, in accordance with the terms of the Order-in-Council 1998/75 of July 16th, 1975, to inquire into and report upon petroleum products pricing, beg to submit respectfully the following Final Report, Part I, for your Honour's consideration.

Commissioner

May 31, 1976

FINAL REPORT, PART I

THE ROYAL COMMISSION

ON

PETROLEUM PRODUCTS PRICING

REFINING AND MARKETING IN ONTARIO

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INTRODUCTION

The central task assigned to the Royal Commission on Petroleum Products Pricing is to consider the petroleum products industry from the point of view of the consumer. This is the first of two parts of the Commission's final report. It deals with refining and marketing in the Province as specified in the terms of reference including pricing, refining, supply, regional price differentials, particularly in the North, and the question whether provincial price controls or related measures are necessary. The second part is still forthcoming and will deal with the questions raised about the supply of crude oil to Ontario. The report is being split in this way because there have been several recent events pertaining to crude that require further reflection by the Commission and it seems undesirable to let them postpone the recommendations pertaining to pricing in the Ontario marketplace.

The first report of September 25, 1975 covered Phase I of the Commission's work and dealt with three subjects that were regarded by the Government as then urgent: the price freeze of July 1975, inventories available to the Province and price increases to be expected following the freeze. A supplement was brought forward on January 14, 1976 at the request of the Government pertaining to the terms of any further price freezes on petroleum products that might be required. The Commission has no further conclusions or recommendations on these topics.

The second part of this final report will include a review of the proceedings of the Commission and contain details of evidence heard and data assembled during Phase I and Phase II. It is sufficient for present purposes to say that the conclusions put forward herein are based on evidence, both oral and documentary, adduced at public hearings of the Commission, stemming from 40 witnesses and comprising some 5,000 pages of testimony and 70 exhibits. Information obtained in this way was supplemented by some statistical data provided in answer to questionnaires sent out by the Commission and used in the aggregate to establish or confirm certain figures for the industry as a whole. In areas that were deemed to be non-controversial, or of collateral significance only, staff studies made by the Commission have been utilized.

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

(a) Competition

Conclusion: The oil industry in Ontario is competitive and with respect to prices consumers are being well served.

(b) Profitability of the major oil companies in Ontario

Conclusion: The companies' earnings and returns on capital employed in refining and marketing operations in Ontario are not high in comparison with those in other Canadian industries and their returns are below their costs of capital.

Recommendation: The companies should include rates of return from refining and marketing in their annual reports.

(c) Inventory Accounting

Conclusion: The oil companies are right in their criticism of the effects of FIFO inventory accounting for income tax purposes on their working capital but a recommendation on this matter is outside the ambit of the Commission.

(d) Federal Price Guidelines for Petroleum Products

Conclusion: The guidelines were incorporated in the comprehensive anti-inflation program and the price controls in question may be regarded by Ontario as adequate on the whole to meet requirements for the time being.

Recommendation: In connection with imports, Ontario should request the Federal Government to reconsider the relative subsidies on imported crude and petroleum products.

(e) Competitive markets or provincial price controls

Conclusions: The existing markets are giving better service to consumers than would result from a regime of continuing price regulation by the Government and the prices would be increased under regulation.

Recommendation: In the interests of consumers, Ontario should avoid the establishment of an agency to regulate prices.

(f) Other provinces' experience with price controls

Conclusion: Ontario should not regard other provinces as models for itself because their circumstances and problems are not the same.

(g) Wholesale prices and consignment sales

Conclusions: There are two important departures from competitive petroleum products pricing, first, between oil companies' posted tankwagon prices for gasoline to dealers and the prices actually realized and, second, between wholesale prices to independents and self-serve prices.

There is no formula by which a government statute could restore desirable balances in these two cases without creating further discrepancies that would be more objectionable to consumers.

Market forces in combination with corrective actions by the companies should be capable of rectifying the situation in due course.

Recommendation: The Minister of Energy should arrange annual consultations with each of the majors commencing a year hence with regard to the progress being achieved in the restoration of more normal pricing relationships and, out of the set of consultations that follow the termination of the AIB regulations by six months or more, should determine whether the markets are then operating as they should or whether some governmental intervention is required.

(h) Rentals charged on retailing premises

Conclusion: There is reason to believe that the existing formulae for levying rents provide incentives to overexpansion at the retail level and may be discriminatory against consumers in low-rent areas, for example, small northern towns.

Recommendation: The companies should reconsider these rents with the objective of moving towards fixed annual rentals that bear a closer relationship to the values of individual properties.

(i) Northern Ontario

Conclusion: In the markets in small northern towns where competition is comparatively weak and prices high, the operating margins of dealers are higher than elsewhere and change will be difficult.

Recommendation: The companies should address themselves to the question of pricing in such communities through provision of the most modern and efficient retailing techniques that are consistent with the size of a particular market, early application in the North of the recommendations pertaining to property rentals and consideration of the relationships between posted prices and actual prices.

(j) Furnace fuel and industrial and commercial products

Conclusions: The selected product markets reviewed are competitive and functioning with at least reasonable efficiency. There is no requirement for governmental intervention.

(k) Uniform wholesale pricing

Conclusion: From the point of view of the consuming public the abolition of the posted price cannot be endorsed at present as leading to increased competition or other identifiable reforms.

(l) Divorcement of retail and wholesale levels

Conclusion: The desirability of divorcement was not established by information put before the Commission or otherwise available to it.

Recommendation: The Government should proceed no further with proposals for divorcement that have been put before it.

(m) Divestiture of retailing operations by the integrated major oil companies

Conclusion: A measure of this kind is neither necessary nor desirable in Ontario.

(n) Prohibition of self-serves operated by oil companies

Conclusion: It is in the interest of consumers that the oil companies not be prevented from getting ahead with rationalized and more efficient modes of distribution including self-serves.

(o) Taxes, royalties and products pricing

Conclusion: An extraordinary divergence has developed between public opinions that are focussed adversely on the oil industry alone and, in contrast, the facts of the current situation. There are even greater public interests involved in the fiscal measures of the federal and provincial governments, which are the larger claimants on the dollar spent by the consumer on petroleum products.

(p) The dealers

Conclusion: Any measures of governmental intervention in the present plight of many lessee dealers and regulation in support of them would have to be justified on grounds other than the interests of consumers to which the Commission is directed.

CHAPTER 1

CONCLUSIONS AND RECOMMENDATIONS

1.1 The petroleum products industry in Ontario includes the oil refineries and an extensive marketing network with numerous participants that distribute gasoline, light fuels including home heating oil and industrial or heavy fuels. Almost all of the crude oil refined in Ontario is transported by pipeline from Western Canada and most of the products are consumed here. Refining is carried on by six of the major oil companies, each of which produces the full range of products.

1.2 The Commission scheduled operations tightly and avoided issues not included in the terms of reference. Two subjects not thus specified were found to underlie everything else, competition in the Province and some problems that were identified in connection with competition. The marketing structure of the petroleum products industry is complex, with interrelated threads between one aspect and another. Some of the questions raised seemed to be quite new and the task of analysis was rendered difficult by the lack of studies done in the past.

1.3 The conclusions and recommendations in the following sections deal with the competition and profitability of the participants in the industry; the role of government in the pricing of petroleum products; and, recommendations made to the Commission during the hearings. The two final sections present opinions formulated by the Commissioner in the course of the inquiry.

(a) Competition

1.4 To examine the present state of competition in refining and marketing in Ontario it is unnecessary to go "upstream" beyond the point at which crude oil is delivered to the refineries at a price controlled by the Federal Government. Most of the petroleum products consumed in Ontario are refined from this crude. In the hearings there was widespread recognition in principle that market competition serves better than governmental regulation to provide incentives for efficiency and to control prices. There was less agreement about the actual extent of competition.

1.5 Because of the relative importance of the seven major companies that conduct business in the Province, the industry is one described by economists as oligopolistic in structure. The evidence shows it to be competitive. Markets are efficiently performing the task of allocation, which means simply

the delivery of products to the right places at the times required. No single company dominates the Ontario market: the smallest of the majors is large enough to make its presence felt and relative market shares have changed in a flexible way. The industry is showing considerable capacity to introduce innovations in methods of retailing and to adapt to changing patterns of demand. Aside from low returns on high capital costs, there are no barriers to entry into any segment of the industry. Profits and returns on capital in Ontario are not only moderate but low for those concerned. It is concluded that the current interests of consumers with respect to prices of petroleum products are being well served by competition within the Province.

1.6 The proposals for change in the industry did not indeed represent the interests of the users of products so much as those of some distributors and retailers who are being squeezed by competition. To be sure, consumers are complaining about prices, and have good reason to do so considering that these have doubled in a few years. It can be said straightway, however, that the increases do not result to any significant extent from events in Ontario that are within the direct jurisdiction of the Provincial Government. They are rather in consequence of the rising prices of crude oil.

(b) Profitability of the Majors in Ontario

1.7 The information in this report on the major oil companies' earnings from refining and marketing in the Province and their returns on capital employed was not previously available. It is concluded that while earnings and returns have risen during the past few years, they are not very high in comparison with those in other Canadian industries and they are below the companies' costs of capital. The Ontario results are based to some extent on estimated allocations to the Province of overhead and employed capital that are national in scope. Commission staff have reviewed these in a sufficient number of instances to be satisfied that the companies have not presented their figures so as to make Ontario returns seem less than they are. On the contrary, the companies have if anything been careful to err in the other direction. Consistent with trends towards increased corporate disclosure and in support of a point made in a brief presented by the Canadian Association of Petroleum Investment Analysts, it is recommended that the major oil companies include in annual reports their rates of return from refining and marketing.

(c) Inventory Accounting

1.8 The first-in, first-out method of inventory accounting, or FIFO, is required by the corporate income tax legislation and has given a misleading impression in recent years that the earnings of the majors were higher than

was actually the case. As governments become more concerned to deal effectively with obstacles to economic productivity it is desirable that they should pay due attention to questions of this kind. Apart from income taxes the companies are, of course, free to present their accounts to their shareholders and the public on a basis other than FIFO but they have not chosen to do so. It is concluded that the oil companies are right in their criticisms of the effects of the first-in, first-out method of inventory accounting on their working capital, but a recommendation on this matter is beyond the ambit of the Commission.

(d) Federal Price Guidelines

1.9 The Commission is required to consider the adequacy of the Federal Government's price guidelines for petroleum products. These are now being administered by the Anti-Inflation Board (AIB) as part of its comprehensive temporary program. The federal policy of holding the domestic price of crude below the world price is made effective in part by a subsidy on imports of crude. From the point of view of the Federal Treasury there can be little question but that price restrictions are needed to ensure that the intended benefits are passed along to the users of petroleum products. Furthermore, there is no reason to exempt the oil industry from an anti-inflation policy that applies to everyone. The restrictions are considered to share with other price control systems some disadvantages and dangers that will become increasingly apparent as they gradually weaken incentives to achieve operating efficiencies. Their inflexibilities will put more and more strain on the allocation system that operates through the market. Some related comments will be made in connection with consignment selling and market structure. The AIB controls are generally designed to allow cost increases to be passed along and therefore interfere less with production processes than might other types of regulation. It is concluded that these controls may be regarded by Ontario as adequate on the whole to meet requirements for the time being.

1.10 There is a matter to be raised, however, having to do with the related subsidies on imports rather than the price regulations. These subsidies appear to be less favourable to imported petroleum products than to crude. Prices in the Province were traditionally restrained by the competition of imports not because these were large in volume but because they might at any time have increased substantially in consequence of small price differentials. It is important to Ontario consumers and to the national economy to make sure that the provincial market is not protected for very long from this kind of price competition. It is recommended that Ontario request the Federal Government to reconsider the relative subsidies on imported crude and petroleum products.

(e) The Choice Between Competitive Markets and Provincial Price Controls

1.11 One of the questions for the Commission is whether Ontario should institute a regime of continuing price controls over petroleum products. The production processes in the industry do not lend themselves to price regulations. With numerous products resulting from the refining of a barrel of crude, it is impossible to say what is the production cost of any single one of them, such as a gallon of home heating oil or of gasoline. A regulatory authority would therefore find no firm guide as to what to do nor would those who tried to formulate the legislation. It is concluded that the existing markets are giving better service to consumers than would result from this sort of governmental regulation and that prices would be increased under regulation. The users of petroleum products would lose a bargain if the Government were to replace the present marketing structure, which creates incentives for operating efficiency and is holding profits down. It is recommended in the interests of consumers that Ontario avoid the establishment of an agency to regulate prices.

(f) Other Provinces

1.12 Nova Scotia and British Columbia have accumulated some experience in control and direction at the retail level with respect to gasoline and related products and each is understood to be giving further consideration to the subject. The Commission is grateful for assistance it has received in obtaining information about these provinces. It is concluded that Ontario should not regard these others as models for itself because their circumstances and problems are not the same. It is perhaps unnecessary to add that these comments do not imply any judgement with regard to the policies either of Nova Scotia or British Columbia.

(g) Wholesale Prices and Consignment Sales

1.13 In examining the markets for the various petroleum products, the Commission found the contentious issues mainly in the merchandising of gasoline. At present the most aggressive price leadership is coming from self-serve stations operated directly by the majors. Gasoline is sold to the independents by the integrated refiners at contractually negotiated prices and, under normal conditions, it is sold to the brand-name lessee dealers of the majors at posted tankwagon prices. These two prices have traditionally been kept in appropriate relationship to each other by competitive market forces.

In present circumstances, which the majors regard as temporary, the posted prices have been effectively replaced by lower wholesale prices on a widespread basis on account of consignment selling. When competition carries retail pump prices below levels at which dealers can afford to pay the posted price, this technique of consignment selling is invoked to guarantee the dealer a minimum fixed operating margin per gallon. While the arrangements for doing this vary from one company to another, consignment selling through lessee dealers has risen to a level where it has become the rule rather than the exception. At the same time, distribution through company-operated self-serves is growing. As things stand consignment selling and direct selling through company-operated stations have risen to about 85 percent of the majors' brand-name sales.

1.14 As far as lessee dealers are concerned, if consignment sales were at a lower level, for example, between 10 percent and 35 percent of a company's branded volume, it might be said that the markets were operating within the normal framework of principles put forward by the majors to justify their pricing structures. As far as the independents are concerned, they would be able to compete for business in their customary fashion if their operating margins were not being unduly squeezed by the self-serve retail prices. In neither of these cases are price relationships at present achieving a competitive balance. While the immediate problems are serious the inquiry found no reason to conclude as yet that the market will not operate to correct the discrepancies.

1.15 To some extent that would be difficult to determine, these anomalies arise because actual market prices are depressed. As the Commission has studied the retail market for gasoline, it has become clear that there is no formula by which a government statute could restore the desirable balances between posted prices to lessees and the realized prices, and between wholesale prices to independents and self-serve prices, without creating further discrepancies that would be more objectionable to consumers. In addition, a period of general anti-inflationary price controls is not the time to seek structural market reforms through other governmental interventions in the same area except at the peril of ending up in confusion. It is concluded that the companies and the markets should be capable of taking the corrective actions stipulated and may have begun to do so, but one way or another the situation should be rectified in due course. It is recommended that the Government, through the Minister of Energy, arrange consultations with each of the majors annually commencing a year hence with regard to the progress being achieved in the restoration of more normal relationships in the sense described. Out of the set of consultations that follows the termination of the AIB regulations by six months or more, the Government should determine whether the discrepancies in question have been dealt with or whether some governmental intervention is required.

(h) Rentals Charged on Retailing Premises

1.16 While the companies have given thought in the past to the rents charged to lessee dealers they do not seem to have given much of it to the effects on retail prices. They should do so. Rents are applied mainly by formula varying with gallonage sold and a percentage of gross income from the service bays rather than in relation to differing property values. It follows that the rental component of the price of gasoline may be discriminatory against consumers in low-rent areas, for example, small northern towns. More generally there is reason to believe that a system of fixed annual rents would be preferable, because it would give less incentive for overexpansion at the retail level. It is recommended that the companies reconsider their approach to rents in the light of pricing considerations with the objective of moving towards fixed annual rents that bear a more approximate relationship to the value of individual properties.

(i) Northern Ontario

1.17 It is in the market areas of comparatively weaker competition that the majors can succeed in collecting their full posted prices and these areas have become fewer. Among those affected are the small isolated communities in the North in which prices are high and these believe that there is discrimination against them. Consumers there have special problems because they are isolated and lack options. Self-serve stations that have been giving competitive price leadership in the cities have not as yet arrived in many northern towns. Here the operating margins of local dealers are in excess of comparable mark-ups elsewhere and change will be difficult in the absence of stronger competition than now exists. At hearings in the North and in additional field contacts it was made evident, however, that there are local desires not to involve the dealer in blame for the prices.

1.18 The companies tended to explain the problem of northern price differentials by comparing prices in the North with posted prices in the cities whence the products are shipped. The resulting differences are generally less than the costs of transport, which latter they calculated accurately. This line of justification has become less convincing as the prices realized by the companies have gone below posted prices in the competitive cities. The possible contribution of property rentals to this problem has already been discussed.

1.19 The questions of pricing are important in the towns affected although their markets are not very large in total. It is recommended that the companies address themselves to these questions in these isolated and less strongly competitive towns through provision of the most modern and efficient retailing techniques that are consistent with the size of a particular market, early application in the North of the recommendations pertaining to property rentals and consideration of the relationships between posted prices and actual prices.

(j) Furnace Fuel and Industrial and Commercial Products

1.20 In the furnace fuel markets, competitive pressures on the producers appear to be less intense than with respect to gasoline. Retail sales typically take place at posted prices. From information submitted and otherwise obtained, the Commission was made aware of individual problems but none of general application.

1.21 Industrial and commercial products were included in the scope of the inquiry along with petroleum products in general but no representations were received from those concerned. Commission staff therefore initiated a number of informal inquiries among the principals concerned. Seven products account for about 92 percent of sales in the industrial/commercial market for petroleum products: heavy fuel oil, motor gasoline, diesel fuel oil, light fuel oil, chemical feedstocks, aviation turbo fuel and asphalt. Examination of selected market segments indicated that conditions are competitive.

1.22 It is concluded that these markets are competitive and functioning with at least reasonable efficiency and there is no requirement for governmental intervention.

(k) Uniform Wholesale Pricing

1.23 With respect to gasoline some submissions were made to the effect that the majors should be required to desist from using posted dealer prices and to sell to dealers on the basis of uniform wholesale prices plus mark-ups determined according to costs involved in the particular line of business. The contentions in support of this were not found to be supported by the evidence brought forward or by other information. Comparing this proposed system with the existing one, the differences are of form rather than substance and the proposed price structure would be no simpler. Under either system, when competition is working well there should be no continuing price discrimination among different categories of trade: when it is not there will be. From the point of view of the consuming public, it is concluded that abolition of the posted price cannot at present be endorsed as leading to increased competition or other identifiable reforms.

(l) Divorcement of Retail and Wholesale Levels

1.24 The Commission heard representations stemming from some of the lessee dealers in gasoline advocating the enactment by Ontario of so-called divorcement legislation to prohibit oil companies from operating their own retail outlets, which they would be allowed, however, to continue to own. Divorcement would be coupled with franchise reforms to secure and strengthen lessee dealers in their relations with the companies that control and direct them. Certainly franchise reform is attractive to many retail dealers. Without reaching any conclusions as to whether these dealers' contentions on the subject may possibly merit further investigation on grounds other than the interest of consumers, it is concluded that the desirability of divorcement and franchise reform were not established by information put before the Commission or otherwise available to it.

(1) While divorcement in the sense defined would liberate lessee dealers from some of the disciplines imposed on them by their parent companies that they find irksome, it would probably lead to higher prices and could not be expected to transform them into competitive purchasers of refined products; and

(2) While divorcement has been promoted in various states of the United States and elsewhere in Canada, there is apparently no record of substantial consideration, adoption and implementation from which Ontario could learn in advance about the consequences of such a major change.

1.25 It is recommended that the Government proceed no further at present with proposals for divorcement that have been put before it.

(m) Divestiture of Retailing

1.26 The Commission received a representation, from one witness in his individual capacity, in favour of divestiture that would go beyond divorcement by prohibiting ownership by the oil companies of sites and facilities used for gasoline retailing. This was put forward as a technique to promote more effective competition. Implementation of the proposal would involve even more planning, legal problems and redeployment of capital investment than would divorcement. It is concluded that a measure of this kind is neither necessary nor desirable in Ontario.

(n) Self-Serve

1.27 The Commission heard recommendations that new and existing self-serve stations should be operated by lessees and the oil companies prohibited from direct operation of them. To the extent that management is required in self-serve the companies will doubtless use lessee operations after an initial period of trial with this mode of retailing. Some of the majors indicated at the hearings that this process is in fact going on. There is no reason to fear that service and repair facilities are going to disappear because of self-serve. Having in mind the practices of much of the automobile service and repair industry and the high costs, there is much to be said in favour of the kind of modernization that has been taking place in gasoline retailing and various companies are finding opportunities in this. It is concluded that it is in the interests of consumers that the oil companies should not be prevented from getting ahead with rationalized and more efficient modes of distribution including the operation of self-serves.

(o) Taxes, Royalties and Products Pricing

1.28 The subject of taxation of petroleum products and of the oil industry will be dealt with factually in the forthcoming Part II of this report but one conclusion about it is relevant here. Prices of gasoline and the other products have continued to rise with the proceeds flowing mainly into taxes and royalties on crude oil production at home and abroad. Only to a small extent are the increases attributable to growth in producers' costs and revenues. The consumer does not see this process in its entirety as he pays for gasoline and home heating oil. As far as the consumer is concerned the company and the dealer are taking his money and they are culpable. As the inquiry proceeded it was concluded as a matter of judgement that an extraordinary gap has developed between expressions of public opinions that are focussed adversely on the oil industry alone and, in contrast, the facts of the current situation. There are even greater public interests involved in the fiscal measures of the federal and provincial governments, which are the larger claimants on the dollars spent by the consumer on petroleum products.

(p) The Dealers

1.29 It is appropriate to complete these conclusions and recommendations on pricing in Ontario by saying that the Commission was impressed by the plight of many retail dealers and there is no single subject on which it laboured harder. Some dealers have been going out of business but this would hardly be alleviated even by the proposals they themselves brought forward. It was not found the the problems are being created by the oil companies out of predatory motives as some dealers allege. Rather it appears to be the

case that all the operations of the petroleum products industry in Ontario are being caught up in the pressures of highly competitive markets and the resulting requirement for fewer more efficient outlets. It is concluded that any measure of governmental intervention and regulation in support of the dealers would have to be justified on grounds other than the interests of consumers to which the Commission is directed.

CHAPTER 2

INDUSTRY STRUCTURE AND PROFITABILITY

2.1 This chapter looks briefly at the structure of the petroleum industry in Ontario, explains the need to look at a company's total sales revenues less costs to evaluate pricing practices, and examines industry returns for refining and marketing activities in the Province. This review is presented in sections on:

(a) structure;

(b) product pricing;

(c) profitability.

STRUCTURE

2.2 The refining segment of the petroleum industry in the Province of Ontario comprises the refineries of six vertically integrated oil production companies: BP Canada, Gulf Oil Canada, Imperial Oil, Shell Canada, Sun Oil and Texaco Canada. Petrofina Canada, another major vertically integrated company, refines in Montreal and markets in Ontario. As yet, there are no independent refiners in Ontario, although there is one in Quebec - Golden Eagle - that supplies part of the retail market. The major oil companies had an annual crude oil throughput to refineries in the Province in 1974 ranging from a low of 16 million barrels to a high of 38 million barrels.* Their combined refining capacity as of December 31, 1975 was 536,000 barrels per calendar day.

2.3 Nearly all the crude oil is transported by pipeline from Western Canada, where the major companies and a large number of others are engaged in exploration and production. The Western crude supplied to Ontario in 1974 totalled 164 million barrels. Some crude oil enters the Province from offshore, but this amounted to only 68,000 barrels in 1974, an insignificant amount. Refined product is also imported into Ontario; in 1974, this product totalled 85.6 million barrels, most of which was supplied

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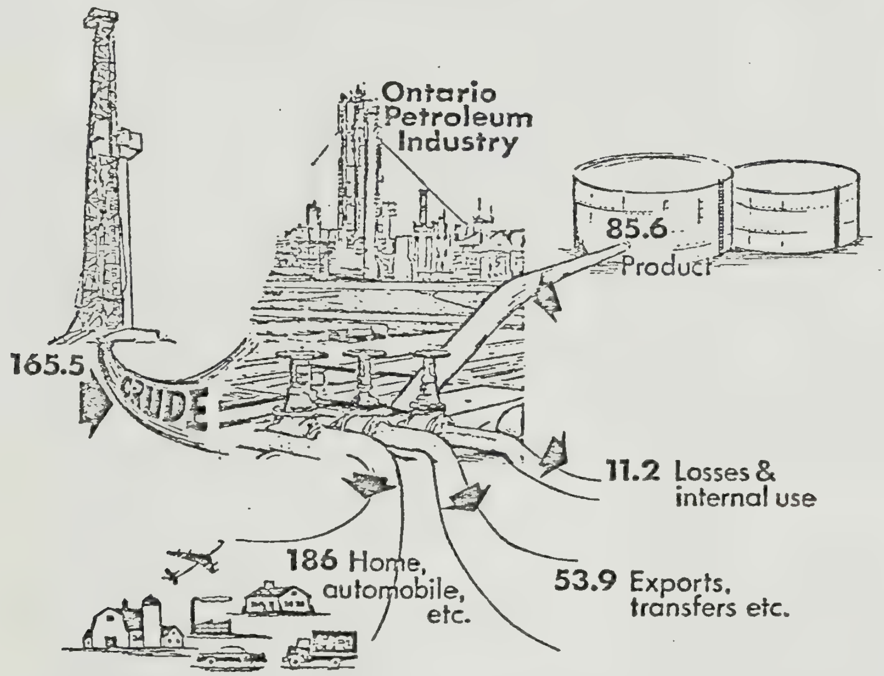
* - A barrel is equivalent to 35 gallons.

by Montreal refineries to markets in Eastern Ontario, east of the Ottawa Valley line established by the National Oil Policy in 1961 to restrict imported crude to Eastern Canada. In addition, parts of Northwestern Ontario are supplied from Manitoba. The exhibit below shows the inflow of crude oil and refined product to the petroleum industry in Ontario by source and the outflow of specific refined products in 1974.

1974 Input-Output of Crude Oil & Petroleum Products for Ontario

MILLIONS OF BARRELS



SOURCE - STATISTICS CANADA, REFINED PETROLEUM PRODUCTS, CAT. NO. 45-004

2.4 The major oil companies are vertically integrated downstream from refining into almost every wholesale and retail product market, and they supply the bulk of the refined products through their own retail, wholesale and industrial channels. However, portions of the wholesale and retail markets for gasoline and home heating oil are served by independent dealers. The independents purchase their product from the Ontario refineries, from Eastern Canadian refineries and, from time to time, from foreign refiners.

2.5 In recent years, the total market for petroleum products in Ontario has grown, rising from 168.9 million barrels in 1971 to a peak of 186.6 million barrels in 1974, but fell to 180.9 million barrels in 1975. Increasing motor gasoline consumption has accounted for more than 80 percent of this growth. Refined product sales in Ontario over the years 1971-74 are summarized in the following table.

NET SALES OF REFINED PETROLEUM
PRODUCTS IN ONTARIO
(Millions of Barrels)

Product / Date	1971	1972	1973	1974	1975
Motor Gasoline	63.8	67.7	74.1	75.8	77.7
Light Fuel Oil	39.7	41.5	38.1	38.3	34.9
Heavy Fuel Oil	27.8	26.7	27.3	26.7	22.1
Diesel Fuel	11.5	12.2	14.0	15.6	16.0
Aviation Turbo	4.7	4.9	5.8	6.9	7.1
Kerosene Stove Oil	3.4	3.1	2.6	2.5	2.3
Other Products*	18.0	19.3	19.8	20.8	20.8
Total Net Sales	168.9	175.4	181.7	186.6	180.9

Source: Statistics Canada, Cat. No. 45-004.

* - Includes light gases, petrochemicals, lubricants, asphalts, etc.

2.6 Nearly half of all refined product is purchased by individual consumers. Of the total sold in 1974, 48 percent was consumed by the motorist and home owner. The remainder was used by industry and government.

PRODUCT PRICING

2.7 Every refinery produces a range of petroleum products, and although it is possible to calculate the cost of refining an average barrel of crude oil, there is no accurate way to allocate this cost among the different products. Oil companies are necessarily interested in their return from a total barrel of crude oil. The fairness of prices and the adequacy of a company's refining

and marketing profits can be assessed only by comparing the total revenue realized from all products with the total cost of refining and marketing them. The unit "costs" of producing a particular product cannot be determined, and the average cost of that product is not a basis for testing whether a price is fair to the consumer or yields a reasonable return to the company. What is significant is the prices of all the products of the refinery taken together. Price differentials exist among products and markets, and are indeed necessary to the efficient allocation of crude oil supplies, investment and petroleum products.

2.8 The following exhibit presents a simplified illustration of the refining and marketing margin on an average gallon of refined product. The actual situation is more varied and complex, as companies refine a great many other products that are distributed in a variety of ways, and their refining costs change with their cost structures and utilization of capacity.

REPRESENTATIVE REVENUE AND COST COMPONENTS
OF ONE GALLON OF AVERAGE REFINED PRODUCT

ILLUSTRATIVE PURPOSE ONLY	Regular gallon of gasoline sold through full-service leased station		Gallon of home heating fuel delivered in Toronto ex Sarnia	Gallon of heavy fuel oil sold ex refinery
Retail price		78.9¢	41.3¢	N.A.
Dealer margin	7.5¢			
Provincial road tax	19.0¢			
Federal sales and excise tax	13.9¢			
Marketing and distribution costs	6.9¢	47.3¢	8.0¢	N.A.
Netback to refinery		31.6¢	33.3¢	22.0¢

Average netback assuming refinery output and sales mix of: 47% regular motor gasoline, 36% home heating fuel and 17% heavy fuel oil		=	30.6¢/gallon
Cost of average product:			
Crude oil delivered Sarnia	$8.75/bbl.		
Refining costs	$ .90		
Total	$9.65/bbl.		
Refining cost including 6% losses and consumption	$10.27/bbl.		
Refined product cost/gallon		=	29.3¢/gallon
Refining and marketing margin		=	1.3¢/gallon

Source: Commission staff

* - Figures used are typical but not attributable to any one company.

2.9 Companies will naturally try to obtain the highest price they can for each product in each segment of the market. Decisions on how much crude oil to run through existing facilities or whether to invest in new refining capacity depend upon the prices expected to be realized from all products.

2.10 The price a company can obtain for a given product in the long term can be affected by the availability and price of substitutes. In the transportation sector, there are no effective substitutes for motor gasoline or diesel oil, and the responsiveness of total consumption to price is quite limited. The price that light oil or home heating oil can command over the long term relates to the prices of competing fuels. In the household sector, the main potential competitors to home heating oil are natural gas and electricity; for commercial and industrial users, the substitutes for light oil are natural gas and heavy fuel oil. Moreover, heavy fuel oil must compete with coal.

PROFITABILITY

2.11 Companies in the industry provided the Commission with data on Ontario and Canadian refining and marketing profits. The preparation of the data by the companies and their interpretation by the Commission required a considerable amount of judgement because of the integrated nature of the companies and the different accounting treatments accorded to some items. Commission staff selectively reviewed a number of the underlying assumptions and calculations, and are satisfied that the data reasonably reflect the industry's refining and marketing results and that no attempt was made to understate performance. In fact, for items where judgement had to be exercised the companies if anything erred towards overstating rather than understating refining and marketing results.

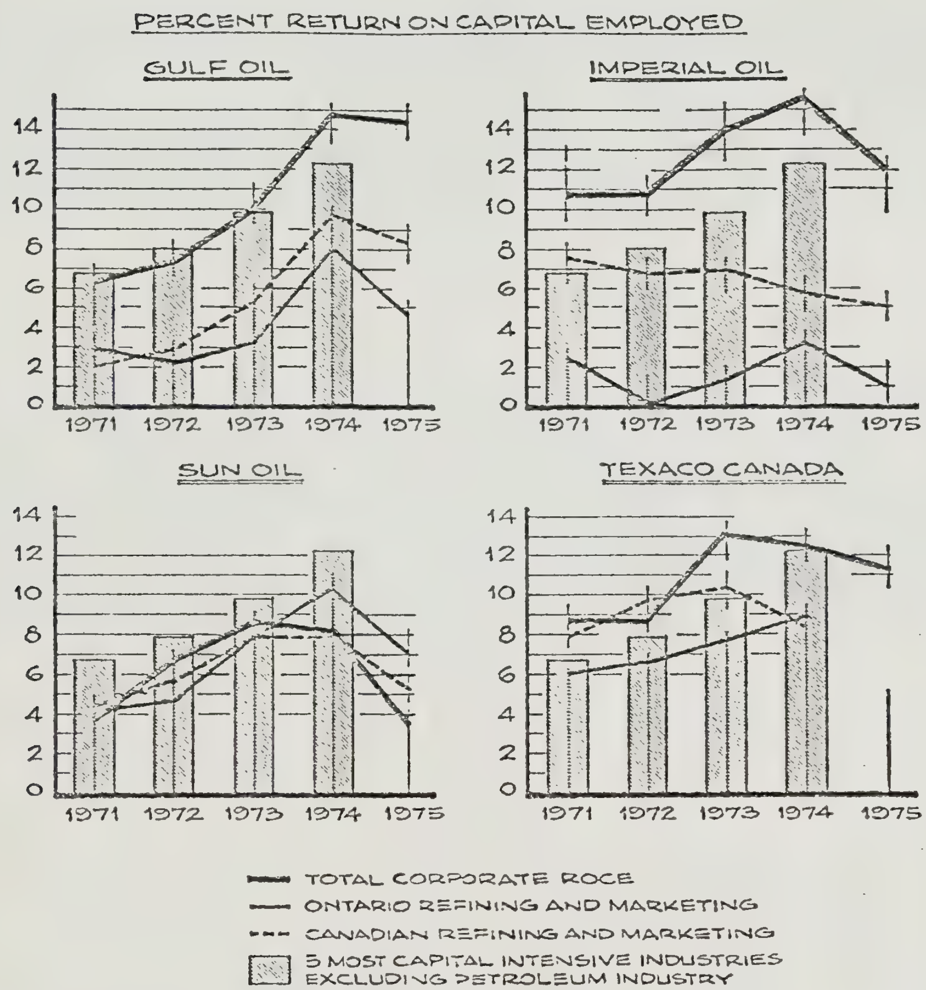
2.12 On the basis of a review of these data it is evident that:

(a) The rate of return on capital employed from total Canadian refining and marketing operations is less than the rate of return for the total company and generally less than that for other capital-intensive Canadian industries.

(b) Ontario refining and marketing returns for each company generally are lower than its returns for total Canadian refining and marketing.

(c) Total Canadian refining and marketing returns have been lower than the industry's cost of capital*.

RETURNS ON CAPITAL EMPLOYED



SOURCE - INFORMATION SUBMITTED BY THE COMPANIES

NOTE: DATA FROM BP CANADA & SHELL CANADA NOT AVAILABLE IN THIS FORM.

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* - The cost of capital is the required rate of return needed to justify the use of capital. Its basis of derivation in the petroleum industry is complex and controversial. Professors D.C. Shaw and J.E. Hatch of the University of Western Ontario, in a paper presented to the Commission in Phase II, calculated Gulf Canada's weighted average after-tax cost of capital to be approximately 14 percent, and suggested that 12 percent is reasonable for refining and marketing. Others argued that there should be no differentiation in the cost of financing different types of capital appropriations. Imperial Oil Limited has contended elsewhere that the rental rates for service station properties should be measured against competitive rates established by the real-estate industry rather than the integrated company's overall cost of capital or its refining and marketing cost of capital, which it estimated at 11 to 12 percent after tax.

2.13 The exhibits above indicate that the industry's refining and marketing returns were significantly higher in 1973 and 1974 than in the early 1970s and in 1975. One of the reasons for this was that the 1973 and 1974 results include inventory profits, and therefore are not indicative of the industry's normal refining and marketing results.

2.14 The Commission received considerable testimony from companies in the first phase that the reporting of profits in a period of rapidly escalating prices was heavily influenced by the accounting approach in use. For example, one company indicated that its 1974 refining and marketing return on capital employed would only have been about 50 percent of that reported had its returns been reported using LIFO (last-in, first-out) rather than FIFO inventory accounting.

* * * * *

2.15 The major oil companies are vertically integrated downstream into every product market. Their returns must be calculated on the basis of combined product revenues less total costs, as unit costs of producing a particular product cannot be determined. At the present time, returns on capital employed in refining and marketing activities in Ontario are less than in other capital-intensive industries and lower than the industry's cost of capital.

CHAPTER 3

REFINING

3.1 A driving force of competition at the refinery level is the need of each company to operate near capacity to produce satisfactory returns, given the large capital investment required to build a refinery. Capacity must be added in large increments, because large refineries enjoy significant economies of scale. The size of new refineries in Ontario has therefore been increasing. As a result, one or more firms in the industry tend to have excess capacity at any given time. This keeps prices competitive, and constrains profits, to the point that rates of return have been comparatively low for some time. This chapter looks at petroleum products refining in the following sections:

(a) product mix;

(b) refining economics;

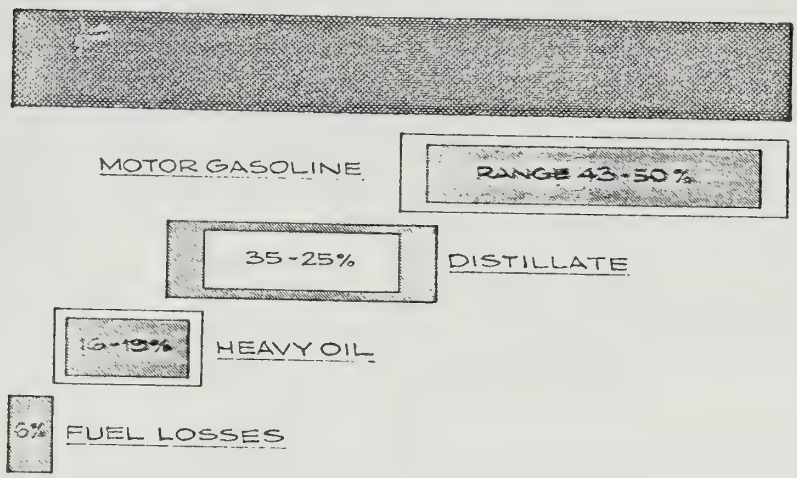
(c) barriers to entry;

(d) competition.

PRODUCT MIX

3.2 Every refinery produces varied and numerous products. Within rather narrow limits, the characteristics of a refinery's crude oil supply and its initial design features determine its possible mix of product output. Refineries are planned, therefore, to match as closely as practicable the anticipated mix of product demand in the area to be served. North American refineries are generally designed to emphasize gasoline production, and secondarily that of distillate fuel oil (heating and diesel fuel), at the expense of heavy fuel oils (residual and bunker oils), which constitute a higher proportion of the total product mix in Europe and East Asia. In Canada and the United States, heavy oils have had to compete in industrial fuel markets with cheap coal and natural gas, so that it pays North American refiners to process their heavier crude oil fractions into lighter and higher priced products like gasoline. The exhibit below illustrates the prominence of gasoline in the mix of products from Ontario refiners.

AVERAGE ONTARIO REFINERY YIELD - 100%



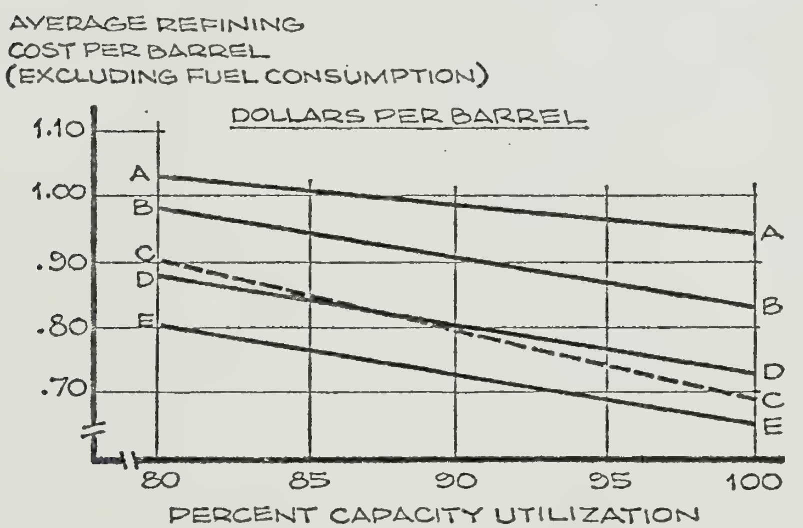
SOURCE - INDUSTRY DATA FROM COMMISSION QUESTIONNAIRE

3.3 No matter how careful the original production plans to which refineries are committed, it is only coincidental if at any time the kinds and volumes of output from any given refinery, or all the refineries in a given market, correspond exactly to the kinds and volumes demanded by consumers in that market. Some of the imbalances between supply and demand mix are seasonal, and can be resolved by storing products. Because there is a relatively fixed output ratio between gasoline and distillate fuels, refiners in Ontario build up gasoline stocks in the winter to be drawn down in the summer when demand is greater, and they build up distillate stocks over the summer to be drawn down in the winter heating season. Sales and purchases in adjoining provinces with different production and consumption mixes can further help refiners to balance supply and demand in Ontario. In the past, imports served similar purposes, but these have been restricted recently. The imbalance between supply and demand that remains after refiners exhaust the economical opportunities available to them to alter refinery output, store product for a more favourable season, or export or import product is unavoidably reflected in the relative prices of different petroleum products. Prices and markets appear to work constantly to match the availability of products to specific consumer requirements. It is notably difficult to find instances where shortages or surpluses of particular products persist for very long, and no problems of this nature were raised at the hearings.

REFINING
ECONOMICS

3.4 The economic performance of a refinery is complex, and depends in part on the size of plant, the level of capital investment, the efficiency of operation and, importantly, the level of capacity utilization. These four factors will vary from one company to another depending particularly upon when a refinery was built or most recently rebuilt. At a given time, some companies have more favourable cost structures than others, and these exert competitive pressure on the higher cost operators to become more efficient. A statistical survey by the Commission shows that, while there are significant differences among companies in cost structures, capacity utilization is of crucial importance to each of them. The recent pattern is fairly typical, although the relationships among the companies obviously may change from one period to another.

AVERAGE REFINING COSTS BY COMPANY IN ONTARIO



SOURCE - INDUSTRY DATA FROM COMMISSION QUESTIONNAIRE

3.5 If significant new capacity could be added in small increments, individual companies and the industry as a whole would be able to balance capacity with demand and maintain high utilization. This is not the case. While additions can sometimes be made to capacity in existing facilities, for example, by increasing pressures, or adding equipment at particular "bottlenecks", there is no practical way to avoid major capacity additions or new refineries. In the period from 1970 to 1974, Ontario refineries operated at reasonably high levels, although overcapacity developed in Eastern Canada, putting pressures on prices here. In 1975, capacity utilization fell to 85.2 percent, with half the refiners operating considerably below this level due to new capacity that came on stream as consumer demand decreased.

CAPACITY UTILIZATION IN ONTARIO REFINERIES

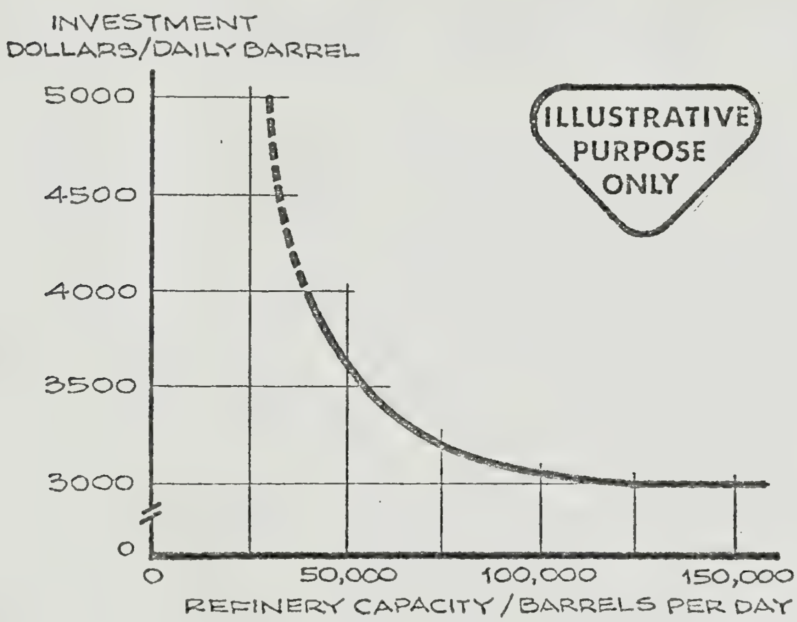
(000's barrels as of December 31 each year)

	1970	1971	1972	1973	1974	1975
Total refining capacity	382.5	396.5	411.5	426.5	489.9	536.6
Actual refining rate	371.1	377.8	375.5	413.1	461.7	457.1
% utilization	97.0	95.3	91.3	96.9	94.2	85.2

Source: Industry data from Commission questionnaire.

3.6 To be competitive at current costs, a "grassroots" or completely new refinery must be able to process in the neighbourhood of 100,000 barrels per day or more. At lower levels, the capital costs per barrel rise significantly. In its submission of February 1976 to the Royal Commission on Corporate Concentration, Imperial Oil Limited commented that "in current dollars, the investment declines from about $4,200 per barrel per day for a 50,000-barrel-per-day plant to $3,200 for a 100,000-barrel plant and to $3,000 for a 140,000-barrel-per-day plant". The sharp decline in cost per barrel as capacity rises is depicted in the following exhibit.

REFINERY CAPITAL INVESTMENT AT CURRENT COSTS PER BARREL OF CAPACITY



SOURCE - SUBMISSION TO ROYAL COMMISSION ON CORPORATE CONCENTRATION BY IMPERIAL OIL LIMITED, 1976

3.7 An objective of management is to obtain enough revenue to recover investment cost over the life of a project, and capital-intensive refining capacity requires high utilization levels to do this. For example, if a company with a 10 percent after-tax cost of capital builds a new 100,000-barrel-per-day refinery costing $300 million with a life expectancy of 20 years, it will require an average after-tax cash flow of $.82 per barrel of input at full capacity to recover the investment cost and service the average investment in the project. If the refinery operates at only 80 percent of its rated capacity, then the cash flow requirement increases by 21¢ per barrel of input to $1.03 - or .64¢ per gallon of output. In an industry where pre-tax refining and marketing margins are measured in terms of tenths of a cent per gallon, such differences are crucial.

BARRIERS TO ENTRY

3.8 There are strong barriers to entry into refining into Ontario, which are economic rather than structural. A new entrant with the ability to pay will have no difficulty in obtaining crude. However, the capital investment required both in refining and distribution is large and growing. The competition that exists in the Province promises a newcomer scant hope of selling the considerable volumes needed to achieve economic utilization levels.

3.9 Petrofina and Murphy Oil (and probably others) have from time to time considered building refineries in Ontario, but to date neither of them has been able to justify the necessary expenditure. It would clearly be difficult for a new refinery to capture the necessary share of the present retail markets for all petroleum products. As vertically integrated oil companies directly supply approximately 80 percent of the retail gasoline market, a new refinery would have to gain either the entire business of the independent dealers, or a sizeable portion of the oil companies' existing retail business to generate sufficient sales volume to be profitable. In addition, market entry would be expensive. This might entail the acquisition of a number of private-brand outlets, as it would be virtually impossible to find enough attractive retail sites to start from scratch. Moreover, retail gasoline is only part of the marketing problem, as refineries produce numerous products that have to be sold.

3.10 The possibility of future entries into refining in Ontario should not, however, be ruled out. Large refineries are currently under construction for Texaco and Petrosar. The latter, while primarily engaged in petrochemical production, will add significant product supply to the petroleum products industry.

COMPETITION

3.11 Competition at the refinery or wholesale level is based on price and reliability of supply, because the physical differences between the products of one refinery and another are of little importance. As a result, companies have found it advantageous to operate directly in retail markets to assure that they have outlets for refined products, and this has the effect of reducing the intensity of wholesale price competition. The major oil companies own retail marketing networks and, in addition, they have

established relationships of various kinds with independent wholesalers and retailers. Vertical integration thus removes some of the risks associated with both the underutilization of refining capacity and price competition at the refinery level. It does not guarantee, however, that sales will equal productive capacity nor does it prevent price competition at the wholesale level.

3.12 Most refining firms will increase sales volumes well beyond their present capacity through processing agreements and inter-company transfers prior to making additions. By these means, a company can approach a position of balance in advance of a major capital expansion. Once the new refinery is built, all the companies share the burden of any excess capacity that results.

3.13 In a certain sense, the overcapacity represents a wasteful use of capital, but in another sense, it is a protection for consumers. If the industry could add significant capacity in small increments, active competition might be less. The competition resulting from overcapacity ensures that consumers are offered competitive prices.

3.14 The history of the industry shows that refiners resort to price cutting in periods of excess capacity. For example, Pioneer Petroleum indicated in testimony to the Commission that several majors are showing a new level of interest in supplying this company now that capacity utilization is low and new capacity is imminent. The incentive is twofold: securing a contract means there will be a contribution to fixed costs and overhead and, once captured, these sales stand a chance of being retained when prices rise.

3.15 During brief periods, refiners may find it advantageous to price at less than average cost, but they cannot afford to price at levels close to marginal costs.* While in the short run it may make sense to price at a marginal level to gain share of market, this procedure will not assist in covering fixed costs, and can lead to disastrous financial results. In the long run, firms must attempt to price at levels that will cover all costs and ensure a fair return on capital. It follows that the industry anticipates above-normal returns part of the time, to offset sub-normal returns at other times, and to justify its investment in refining.

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* - It is possible to estimate the marginal cost of any specific product, which is the cost of producing an extra barrel, although it is not possible to determine an average cost on a product-by-product basis. The joint-cost problems associated with the total range of products derived from one raw material were discussed in Chapter 2.

*   *   *   *   *

3.16 While strong barriers to entry exist in refining, there are a number of forces at work primarily related to the problems of matching demand and supply of refinery output that tend to keep the refining industry competitive and efficient.

CHAPTER 4

GASOLINE RETAILING

4.1 The entry into gasoline retailing of independent dealers competing on price has had an important impact on the nature of competition and retail capacity in this market over the past 20 years. To some degree, the major oil companies have tried to maintain separate and distinct strategies in the price and non-price segments of the market, and have continued to challenge each other for share of both segments. In recent years, however, they have adopted new modes of retailing that are price-competitive with the independents, who by 1974 captured approximately 20 percent of the market. Today, with crude prices higher and the price sensitivity of consumers increasing, price competition dominates the market, and retail overcapacity is being reduced.

4.2 This chapter reviews the development of gasoline retail in the following sections:

(a) overcapacity in the 1950s;

(b) the growth of the independents;

(c) the trend to retailing efficiency.

OVERCAPACITY IN THE 1950s

4.3 Overcapacity in gasoline retailing reached its peak in the late 1950s. Competition appears to have been manifested mainly in areas other than price. This does not mean there was no competition in the market. The major oil companies vied for the most favourable sites, stressed brand image in their advertising, and offered the consumer a variety of service alternatives and consumer promotions.

4.4 However, the most promising strategy for a company was to expand the number of its outlets. Each new outlet a company opened would take some volume away from its existing stations, but the volume gained from competitive brands would result in a net increase for the company. The operating principle of that time can perhaps best be expressed as follows. It paid a company to expand the number of its outlets to the point at which the increased revenues from an additional station equalled the costs of building it and maintaining a lessee operation.

4.5 It appears in retrospect that there were more stations in the market than consumers demanded for convenience, and that consumers were paying higher prices than necessary in consequence. The industry generally acknowledges that overexpansion took place in gasoline retailing, and the companies are currently in the process of correcting this.

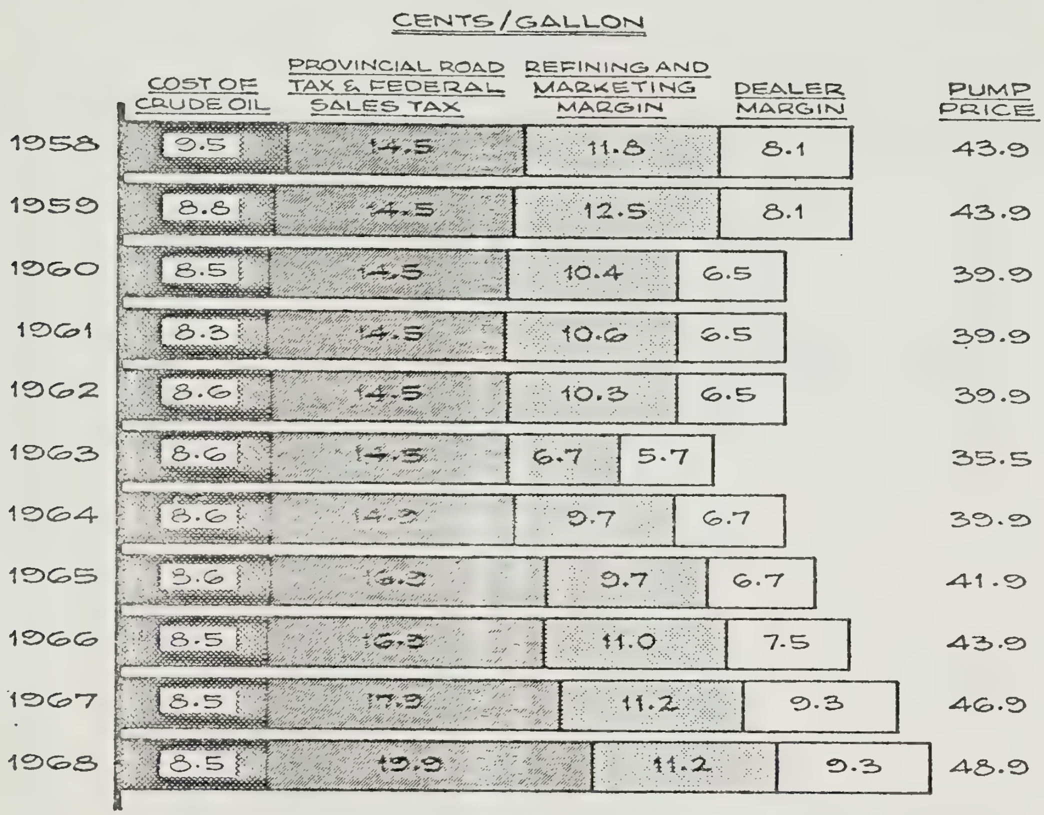
THE GROWTH OF THE INDEPENDENTS

4.6 With overcapacity in gasoline retailing, high retail margins were needed to support the large number of low-volume outlets. These margins allowed the independents to enter the market by cutting prices in the early 1960s. The majors were willing to supply the independents, just as today. The independents provided an opportunity for all refiners to improve utilization, and it was therefore advantageous to sell to them at negotiated prices.

4.7 There are two main categories of independent retailers. The private-brand retailers, such as Canadian Tire, Spur Oil and Pioneer Petroleum, offer many of the services (repair, credit card, brand advertising) that the majors do. They introduced low prices and, in the case of Canadian Tire, cross-merchandising with other products, and showed the industry that even with lower margins, fair returns are possible. The other group of independents are the so-called "price brand" dealers, who typically are small firms with one to five outlets in a local area. They compete on a price basis, and offer few if any services.

4.8 The inroads the independents made into the Ontario gasoline market were soon challenged by the majors. Severe price competition resulted, and wholesale and retail margins fell dramatically. Between 1959 and 1963, for example, combined wholesale and retail margins fell from 20.6¢ per gallon to 12.4¢ per gallon in Toronto, as shown in the following exhibit.

COMPONENTS OF PUMP PRICE OF MOTOR GASOLINE IN TORONTO

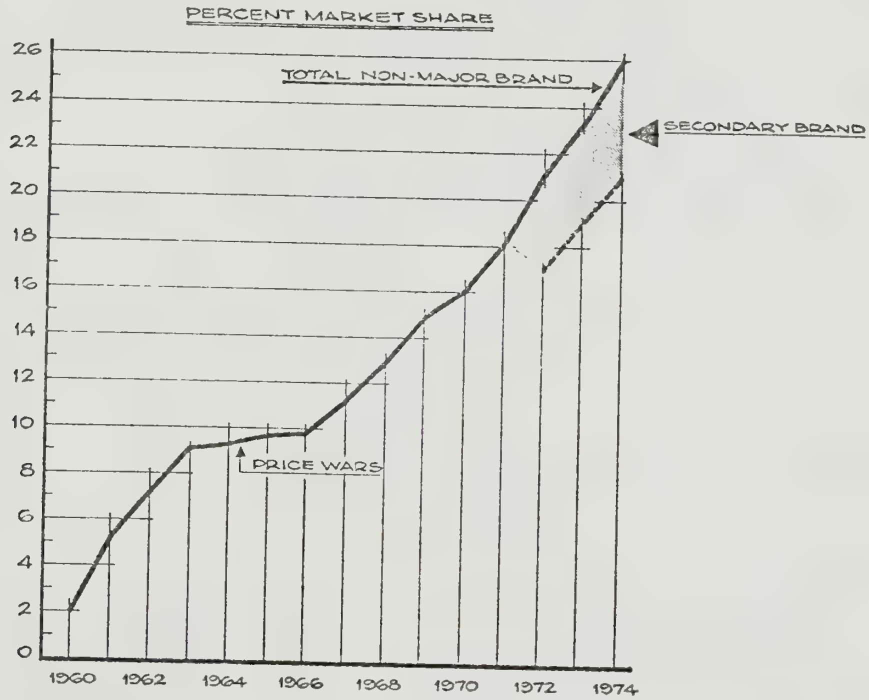


SOURCE – GULF OIL CANADA LIMITED, "GASOLINE RETAILING", APRIL, 1976

4.9 The majors introduced secondary brands to compete with the independents on a price basis, and in this way avoided competitive price cutting on their total brand volume. Their major brand outlets continued to offer more services and a higher quality image, and consequently charged higher prices. Combined wholesale and retail margins bounced back, moving in Toronto from the 1963 low of 12.4¢ per gallon to 20.5¢ in 1967-68, and consumer promotion became the primary means of competition among major brands.

4.10 Throughout periods of price competition and the introduction of the major secondary brands, the independents have continued to grow. In 1974 they held approximately 20 percent of the total retail gasoline market. However, there is some suggestion that, with the introduction of self-serve, there has been a slight decline in their share since then.

GROWTH OF NON-MAJOR BRAND SEGMENT IN ONTARIO



SOURCES - PHASE II SUBMISSIONS OF IMPERIAL OIL LIMITED, DECEMBER, 1975
INDUSTRY DATA FROM COMMISSION QUESTIONNAIRE.

THE TREND TO RETAILING EFFICIENCY

4.11 By the early 1970s, the number of consumers making choices on the basis of price had grown, and this, combined with other trends, including higher labour costs, increased capital costs and growth in specialty repair shops, caused the major oil companies to re-examine their marketing efforts. The companies evolved new strategies that capitalized on the

increasing price sensitivity of consumers, and they competed directly with the independents in the growing price segment of the market. To compete effectively, the companies needed new approaches and efficiencies. Evidence before the Commission indicates that significant changes have taken place in gasoline retailing.

(a) Companies have moved to cut out overcapacity in outlets. The total number of brand stations decreased from 11,764 in 1972 to 9,150 in 1976.

REDUCTION OF TOTAL NUMBER OF

BRANDED SERVICE STATIONS IN ONTARIO

Year	1972	1973	1974	1975	1976
No. of stations	11,764	11,509	10,802	10,063	9,150

Source: 1. Automotive Mass Marketer, 1972-76, Wadham Publications Ltd.

2. Submissions to the Commission.

(b) Gasoline has been cross-merchandised with the car wash to compete in a unique segment of the price market.

(c) Self-serve outlets are replacing conventional stations in order to cut operating costs, attract higher gasoline volumes and improve returns on capital employed, and are meeting wide consumer acceptance.

GROWTH AND CONVERSION OF COMPANY-OWNED

AND OPERATED OUTLETS TO SELF-SERVE*

	1971	1972	1973	1974		1975	
Company O & O							
- Full-Service	194	332	442	276	455	271	541
- Self-Serve	Data not available			179		270	

Source: Industry data from Commission questionnaire.

* - Excluding outlets of BP Canada, which took over Supertest during the period.

(d) Brand advertising and promotion expenditures have been cut. Imperial Oil submitted evidence showing that over the last four years it has cut its brand advertising and promotion costs by 70 percent, or approximately 1¢ per gallon.

4.12 The results of these efforts by the major oil companies to achieve new retailing efficiencies have been significant.

(a) Average volume per outlet has been increasing, particularly in company-owned and operated stations.

AVERAGE SALES RETAIL GASOLINE/BRANDED OUTLET
(000's gallons/year)

	1972	1973	1974	% gain
Co. O & O	488	511	662	48
Co. O & Leased	264	270	278	5
Co. Financed & Other	76	92	106	39

Source: Industry data from Commission questionnaire.

(b) Service station capital is being employed more efficiently. For example, Imperial Oil testified that it has had a 17 percent saving in service station capital employed on a per-gallon basis over the last four years.

(c) Retailing costs have been cut through the use of self-serve outlets. Evidence to the Commission showed the difference in operating cost between self-serve stations and conventional outlets is approximately 5¢ per gallon, as illustrated by the following table.

APPROXIMATE AVERAGE SERVICE STATION*

OPERATING COSTS**

December 1975

	Self-Serve	Conventional
	(Cents per Gallon)	
Retail	4.4	6.6
Facility	2.5	4.4
Merchandising	1.0	2.0
Credit/Accounting	3.0	3.1
Other	1.3	1.3
	12.2	17.4

Source: Imperial Oil brief to the Royal Commission on Petroleum Products Pricing, March 1976

* - All types of outlets, branded and unbranded

**- Figures include 10 percent after-tax return on capital.

4.13 The consumer has benefited from the recent trend towards increased marketing efficiency. The widespread introduction of self-serve has provided easy access for the consumer to low-price outlets throughout most major markets. The price differentials among outlets are illustrated in the following table.

COMPARISON OF REPRESENTATIVE PRICES BY TYPE OF OUTLET

TORONTO, APRIL 1976

Outlet Type	Regular Price	Price differential from Full-Service Lessee
	(Cents per Gallon)	
Full-Service Branded Lessee	84.9	
Full-Service Branded Lessee (Consignment)	77.9	(-7.0)
Company-Owned Self-Serve	74.9	(-10.0)
Private Brand	74.9	(-10.0)
Price Brand	73.9	(-11.0)

Source: Commission survey.

4.14 With the competition in the market caused by the transition to self-serve, refiners are underrealizing their wholesale prices, and all classes of retail outlets are experiencing reduced retail margins. While the weighted average posted tankwagon price* has risen five times since October 1973 to reflect crude price, tax and cost increases, doubling to 55¢ per gallon, the industry has not fully realized the allowed increases.

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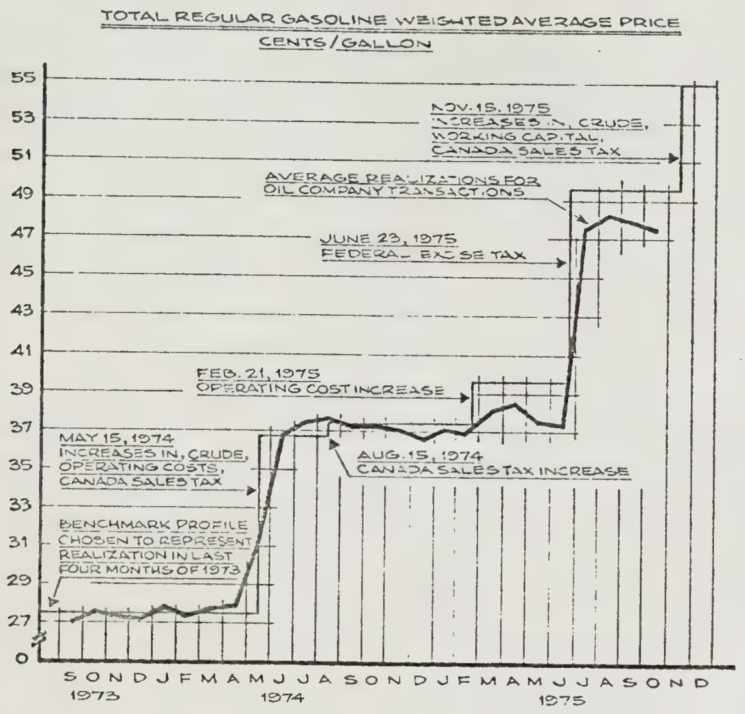
* - Tankwagon price is a branded dealer price including marketing and credit card services, transportation and part of the real estate and facility charges. The weighted average tankwagon price excludes dealer margin and provincial road tax.

REALIZED MOTOR GASOLINE TANKWAGON PRICES



SOURCE - ENERGY SUPPLY ALLOCATION BOARD SUBMISSION, MARCH 1976

It must be emphasized that this is of course a weighted average figure. In some parts of the Province, the industry is realizing full dealer tank-wagon prices.

* * * * *

4.15 The consumer in most parts of the Province is, therefore, currently enjoying very competitive prices. And the industry has shown it is capable of moving to correct its inefficiencies. Overcapacity in refining and more efficient trends in retailing have come together to produce fierce price competition as each participant in the market tries to hold or expand share and preempt market position. A period of transition such as the self-serve expansion provides opportunities for all companies to improve their longer-term position in the market. It is in the public interest that the cost savings that have been achieved continue to benefit the consumer when the transitional phase is over.

CHAPTER 5

PROBLEMS IN GASOLINE RETAILING

5.1 It is evident from Chapter 4 that the refining and marketing of gasoline in Ontario are competitive, and that consumers are generally well served. There are a number of practices in the retailing of gasoline that have led to certain inequities and inefficiencies; however, it is concluded that the companies and the markets should be capable of the necessary corrective actions.

5.2 These practices have generally arisen out of competitive actions in the market. In the use of commission consignment, for example, the oil companies appear to have responded to changing conditions in gasoline retailing, in the interest of increasing efficiency and retaining their market share. Similarly, the method of collecting rents was developed when real estate values were less important to the total cost of doing business. And the independent and lessee are both being squeezed by competitive retail prices. These problems are discussed in the following sections:

(a) commission consignment;

(b) rents;

(c) northern communities;

(d) the independents;

(e) the lessee.

COMMISSION CONSIGNMENT

5.3 Commission consignment is a form of support of the dealer by which the company guarantees the dealer a minimum margin during periods of depressed retail prices. The dealer enters into consignment on his own request, but once the dealer is committed, the company generally sets the price. Under such an arrangement, the oil companies accept a wholesale price that is lower than posted tankwagon (now approximately 70.4¢ versus 75.1¢ per gallon), while dealers accept lower than normal margins (approximately 7.5¢ versus 9.8¢ per gallon). Companies execute consignment arrangements in various manners. Some companies actually retain ownership of the gasoline in the storage tank at the service station with the lessee acting as an agent, while others ask the dealer to pay a lower wholesale price based on a discount from the retail price the oil companies set for the market.

5.4 Historically, commission consignment was used selectively by oil companies to sustain the viability of lessee operators with limited financial resources through temporary periods of excessive competition. At present, commission consignment is so widely practised in Ontario that it has effectively reduced the wholesale price of gasoline in much of the Province. The proportion of branded gasoline sales by volume normally on commission consignment in Ontario has been in the range of 15 to 35 percent, but over the last year has risen sharply.

PERCENTAGE OF IMPERIAL OIL VOLUME

ON CONSIGNMENT IN ONTARIO

1972	1973	1974	1975
18	35	14	63

Source: Phase II "Submission of Imperial Oil Limited Concerning Retail Issues", March 1976.

With consignment selling at the recent high levels, the greater part of provincial volume is subject to company retail pricing. In January, 1976, consignment sales together with companies' direct sales at retail exceeded 85 percent of total volume.

5.5 Commission consignment permits the oil companies to meet local competition without dropping their wholesale price in every market. There is a fine line between meeting and disciplining the competition. Commission consignment is a potential device for disciplining price cutters and, in an extreme case, for initiating a price war. The practice affords protection, nevertheless, to small businesses with limited financial resources. However, those parts of the province where similar competitive conditions are not present pay a higher wholesale price than that effectively charged in most of Ontario - as much as 4.7¢ per gallon - and consequently, higher retail prices as well.

5.6 It is not clear that the elimination of consignment selling would have desirable consequences for the industry, for dealers or for consumers, and no convincing evidence was presented to show that it threatens the process of rationalization that is currently taking place in the retail sector. New efficiencies are being achieved in retailing through reduction of outlets, and the selected use of consignment can help both the companies and the dealers to weather the period of rationalization. Testimony in the hearings indicated that, without consignment or temporary dealer-support plans, companies

fearing the harmful effects such cuts could have on their lessee-dealer networks would be hesitant to pass the lower costs associated with the new efficiencies on to the consumer.

5.7 However, the current situation is not ideal. Commission consignment has gone beyond being temporary and selective as intended. When the total sales volume subject to retail pricing by the companies is as high as 85 percent, a new and lower wholesale price has in effect been created in the market. Those who are still paying the posted tankwagon price, such as the small communities in Northern Ontario, are suffering some consequent disadvantage.

RENTS

5.8 Rents customarily are viewed as a fixed charge relating to the annual carrying costs of land and facilities of a particular location. Rents then vary from location to location in relation mainly to differing property values. In practice, the industry does not collect its rents in this manner. To provide lessees with some protection from the risks inherent in volume and price fluctuation, companies have generally based rental charges on sales volume rather than on property values. While company formulae differ, rents come from two sources, a percentage of gross income from the service bays and a charge for each gallon of gasoline sold. The volume formula for levying rent does not vary from one location to another.

5.9 There is reason to believe that the treatment of rents by the industry in this way, on a variable rather than a fixed-cost basis, can generate excess capacity and inefficiency in retailing. The practice encourages excess capacity when a lessee outlet with low volumes pays less rent than the annual carrying costs to the oil company of its land and facilities, and helps the lessee to survive in the marketplace.

5.10 The concept of rent subsidy is complex, and in the hearings there was a considerable divergence of opinion about it. One company stated that, after charging a rental of 1.4¢ per gallon on gasoline sold and 5 percent of the retail dollar value of other products and services, revenues generated fell short of covering its costs by approximately 2.0¢ per gallon. Others concluded from this that rents are subsidized. However, increasing rental charges by 2.0¢ per gallon (or any other amount) or increasing the percentage charged on the retail value of other products and services sold would not deal with the problem. The theoretical shortfall of 2.0¢ per gallon rent that is not paid directly can be considered part of the posted tankwagon price of each gallon sold and part of the wholesale price of other company products supplied to the dealer (e.g., tires, batteries, accessories). It is the treatment of

rents on a variable basis that can lead to an implicit rent subsidy. Moreover, variable rent charges probably discriminate against consumers in low-rent areas in favour of those in higher areas because they are based on the average case.

5.11 In the same manner, a general formula may well have the result of requiring high-volume operations to pay more rent than would normally be associated with their location. It is perhaps not surprising, therefore, that when companies entered the high-volume self-serve market, they did so on an owned and operated basis.

5.12 The manner in which rents are collected may have added to the overcapacity situation in the 1960s. Today, while variable rents still cause some inequities, they have not, in fairness to the oil companies, stopped the companies from eliminating their marginal outlets.

NORTHERN COMMUNITIES

5.13 Some price discrepancies exist between the retail gasoline markets in isolated communities and larger urban centres. While there is a general problem in isolated communities across the Province, it was in the North that the Commission heard evidence and it is this area to which it has given particular attention. The northern centres of concern do not include the larger cities of Thunder Bay, Sault Ste. Marie, Timmins and North Bay, where prices were found to be at the retail levels comparable to those in southern Ontario when adjusted for transportation cost differentials. Differences elsewhere in the North run as high as 19¢ per gallon. In Kapuskasing and Kenora, where the Commission held hearings, the differences were 13.4¢ and 13.1¢ per gallon respectively. In February 1976, regular grade gasoline was selling for 91.3¢ in Kapuskasing and 91.0¢ in Kenora compared to 77.9¢ in Toronto at stations offering similar products and service.

5.14 Evidence at the hearings provided the basis for determining the components of the isolated community price differential. These include increased costs of transportation to the more remote areas, differences in the realization of the posted tankwagon price and higher dealer margins. The problem of the price differential is typified by the 13.4¢ Kapuskasing difference, which breaks down as follows.

(a) Transportation costs account for 5.4¢. A major company sets its listed dealer tankwagon price for each area of the province to take account of differences in transporting the

product to remote locations. However, in most instances, the company does not recover the full costs of transporting product to northern regions. In Kapuskasing, the dealer tankwagon price is 80.5¢ compared to 75.1¢ in Toronto, for a difference of 5.4¢. Kapuskasing receives most of its product from Ontario refineries at a cost of approximately 10.0¢ per gallon including charges for investment in additional physical assets and inventories, while Toronto receives its product at a cost of .9¢ per gallon. Only 5.4¢ of the 9.1¢ per gallon differential in transportation cost for Kapuskasing is recovered by the increased tankwagon price, for a net underrecovery of transportation cost of 3.7¢.

(b) Differences in realization of tankwagon price account for 4.7¢. Full listed tankwagon price is not realized on gasoline sales to dealers in most of the Province at this time, but in the more isolated communities, the dealer pays the full listed price. The full-service station dealer selling regular gasoline at 77.9¢ in Toronto receives a commission of 7.5¢ to sell the product, paying the equivalent of a wholesale price of 70.4¢, as compared to the listed tankwagon price excluding transportation differences paid in Kapuskasing of 75.1¢.

(c) Higher dealer margins account for 3.3¢. Dealer margins in the North are higher than in most southern areas, where dealers are on commission consignment and their effective margin is 7.5¢. In Kapuskasing margins were 10.8¢ or 3.3¢ higher. This difference may be somewhat overstated, as there was some indication that regular retail customers receive discounts. In citing this difference in dealer margins, the Commission is not taking a position on what level of margin is appropriate. The Commission received no evidence in its hearings, however, to support the position that the higher margins are necessary to sustain lower average volumes in smaller communities, and questionnaire returns indicated that average volumes in major brand stations in these communities are comparable to those of stations in urban markets. In addition, no cost evidence was presented to support the difference.

5.15 In summary, the components of the northern price differential as illustrated by the case of Kapuskasing were:

PRICE COMPONENT	COST PER GALLON
Transportation costs	5.4¢
Full realization of posted tankwagon	4.7¢
Higher dealer margins	3.3¢
Total difference:	13.4¢

5.16 Of this 13.4¢ per gallon difference, 8.0¢ are price components that reflect a lower level of competition in the market. When the 3.7¢ transportation underrealization is taken into account, the total price disadvantage that Kapuskasing suffers is 4.3¢ per gallon.

THE INDEPENDENTS

5.17 The independents are currently caught in a battle for market share with the major oil companies. The majors have priced their self-serve outlets equivalent to or below independents. Testimony showed that the majors have introduced the low prices in the present market in competition with each other and the independents for greater volume in the price sensitive segment of the market. A price comparison based on information in Imperial Oil's March 1976 brief to the Commission illustrates the kind of severe margin pressures that the independents currently face.

TYPICAL NETBACK
ON REGULAR GASOLINE IN DECEMBER 1975
(Cents/Gallon)

	Esso Leased -Full-Service	Esso Direct -Self-Serve	Econo	Private Brand
Retail Price	78.9	75.3	75.3	
Retail Margin	7.5			
Dealer Price	71.4			65.4
Taxes	32.9	32.9	32.9	32.9
Revenue to Imperial	38.5	42.4	42.4	32.5
Imperial Costs*				
Retail		4.4	7.0	
Facility	3.5	2.5	5.1	
Merchandising	2.0	1.0	0.3	0.2
Credit/Accounting	3.1	3.0	0.2	0.2
Other	1.3	1.3	0.6	0.4
	9.9	12.2	13.2	0.8
Netback to Refinery	28.6	30.2	29.2	31.7

Source: Imperial Oil brief to the Commission, March 1976.

* - Includes 10 percent return on facility investment after tax.

5.18 In this example, the owned and operated self-serve stations' retail selling price is 75.3¢, and to be competitive the private brand station must obviously match it. Since the private-brand station pays 65.4¢ per gallon, its retail margin is 9.9¢. According to the testimony of Pioneer Petroleum, independent private brand retail and facility costs would be similar but somewhat less on a per-unit basis than those shown for Econo at 13.2¢, because private-brand volumes are generally significantly greater than those of Econo stations. Nevertheless, with the private-brand margin in the order of 9.9¢ for an extended period, private-brand earnings could fall dramatically. And where self-serve prices drop below 75.3¢, as has occurred in some instances early in 1976, margin pressures would be even more severe.

5.19 From the standpoint of the majors, the netback to refiners in the situation described is greater for independents than for company-operated self-serve and secondary brands. In consequence, the independents are at present being required to survive on lower margins than the oil companies can afford themselves, and it can be concluded that the independents' financial squeeze is unrelated to their efficiency as retailers. Some small independents have been forced to close, and others appear to be under extreme pressure.

5.20 In periods of excess capacity, this financial squeeze should be temporary. There is a competitive relationship between oil companies seeking the independents' business. Prices may differ according to the amount of excess capacity of the refiner, the purchasing power of the independent, the reliability of the oil company to offer reasonable prices over the long term and so on. And, since the hearings, prices have begun to rise and some of the pressures are possibly abating.

5.21 It is clear that the independents have been a prime force in creating and sustaining price competition of significant benefit to the consumer. Moreover, as long as independents remain efficient, their continued presence in the market is strong insurance for lasting competition. The independents' situation continues to bear watching - particularly as the oil companies both sell to them at wholesale and compete with them at retail.

THE LESSEE

5.22 This recent period of industry rationalization has been difficult for the dealers. The concerns of the dealers were represented by several organizations such as the Ontario Retail Gasoline and Automotive Service Association, the Automotive Trade Associations of Ontario and Canada, the Canadian Carwash Association and the Canadian Federation of Independent Business. Concerns expressed by lessees focussed on the growing competition of company-owned outlets, current pricing practices, the widespread use of consignment and low margins.

5.23 To survive in the current price market, the lessees have had no better choice than to go on consignment and accept margins that are considerably lower than if normal prices prevailed. According to testimony, consignment margins typically are about 7.5¢ per gallon. In the example below, a comparison of lessee situations in Toronto shows that the dealer margin on consignment is 2.3¢ per gallon less than in the normal situation.

ABSORPTION OF DISCOUNT PRICES

TORONTO, APRIL 1976

	Normal Situation	Consignment Situation	Difference in Two Situations
Wholesale Price	75.1¢	70.4¢	4.7¢
Retail Price	84.9¢	77.9¢	7.0¢
Lessee Margin	9.8¢	7.5¢	2.3¢

Source: Commission survey.

5.24 The lessee is effectively an extension of the integrated oil company rather than an independent competitor and is likely to remain so. The oil company has invested in the land, service bays, pumps and storage tanks for a station, and has the option of running the outlet directly or leasing it to a dealer. There are some constraints on the oil company in direct operation, and these tend to enhance the attractiveness to the company of the leasing arrangement. If managers turned over continuously, or the company could not recruit the right kind of people with its present salaries, then the company would have to raise its pay scales, and suffer reduced margins. But the lessee's problem is the greater. As long as people are free to enter gasoline retailing as lessees, and are willing to face low profits and a high possibility of bankruptcy, then competition for dealerships will keep retail margins down and perpetuate low earnings.

5.25 With the trend to fewer high-volume outlets, some lessees will naturally be forced out of the market. For those that remain, their current low earnings situation may be temporary. New efficiencies in gasoline retailing will mean lower retail margins, but as rationalization proceeds, the number of stations offering both gasoline and service will decrease, with the result that repair and gasoline volume should increase for those

remaining. With the increased volumes, dealers will be able to enjoy satisfactory returns with low margins. Moreover, good dealers will always be in demand. It is obviously in the best interest of the oil companies to attract good dealers by providing an environment in which dealers can receive adequate income.

* * * * *

5.26 The market inequities discussed above for the most part are a result of the transition in the retail market for gasoline to more efficient outlets. While the market is shifting towards a more appropriate relationship between consumer price and number of outlets, it bears watching to ensure that this trend continues and the current inequities are corrected over time.

CHAPTER 6

FURNACE FUEL OIL

6.1 The market for furnace fuel oils has two components: (1) home owners together with small commercial establishments; and, (2) large-volume consumers: manufacturers, large commercial establishments, institutions and government. An estimated 74 percent of the furnace fuels sold in Ontario serves the home ower, while the remainder serves the industrial/commercial market. This chapter examines the structure and the nature of competition in the furnace fuel market in the following sections:

(a) market structure;

(b) competition.

MARKET STRUCTURE

6.2 The major oil companies sell directly to the large-volume purchasers in Ontario and serve over 80 percent of the retail furnace fuel oil market as well. They distribute the product to the household market through their furnace fuel divisions in large urban locations or through company agents and distributors in small centres and rural areas. The furnace fuel division operates a fleet of trucks from a central dispatch in each major market area, while the agents and distributors service their accounts with their own trucks. These agents and distributors are paid on a commission basis, and receive sales support, brand advertising and a line of credit that they may extend to their customers.

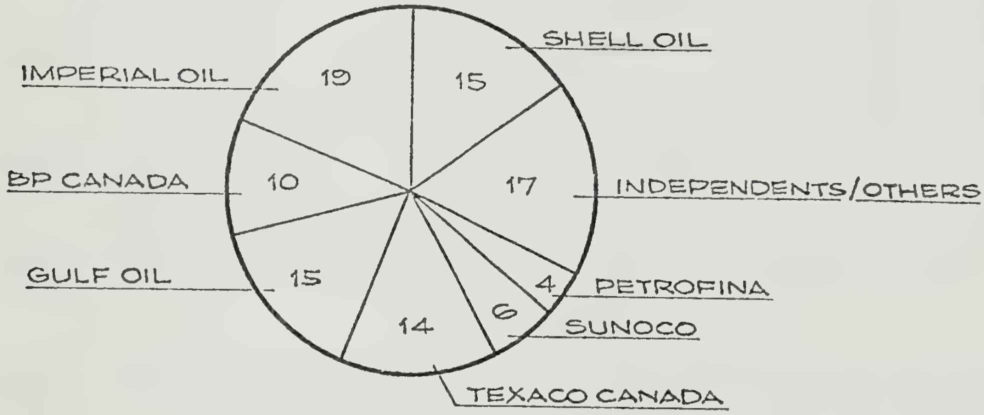
6.3 Storage capacity is an important factor in the marketing of furnace fuel oil for both refiners and distributors in Ontario. Because refineries necessarily produce a mix of products throughout the year, heating fuel must be stored through the summer months to supplement winter production. Some refiners produce furnace fuel in excess of their storage capacity, so an independent distribution company with large storage capacity can relieve a refinery of some of the need for storage.

6.4 The largest independent wholesaler and retailer of home heating oil in Ontario is Canadian Fuel Marketers. CFM has storage capacity comparable to that of any major company in the province and thus a competitive advantage

in negotiating for wholesale price. CFM currently does business with 72 independent dealers and 11 wholly owned dealers within the province of Ontario. Approximately 250 other independent dealers operate in the province, all of whom have very limited storage facilities, if any. These dealers acquire their product from major refiners either on a contract or a spot basis, and purchase foreign product from time to time.

6.5 In 1974, sales to the home heating oil market totalled 28.3 million barrels. A breakdown of retail market shares in Ontario is illustrated in the exhibit below.

HOME FUEL OIL MARKET SHARES



SOURCE - SUBMISSION OF IMPERIAL OIL, PHASE II; DECEMBER 1975

COMPETITION

6.6 Few consumers of furnace fuel oil can change to other fuels easily. Major changes in the relative prices of different fuels would be required to make it worthwhile for home owners or industry to scrap working furnaces or boilers in order to switch fuel. For this reason, most changes take place on new purchase decisions, and consumption of furnace fuel oil adjusts only very slowly to changes in its price and the prices of other fuels.

6.7 Within the furnace fuel market, price is of less importance in home and small business purchases than in industrial/commercial buying. Industrial/commercial consumers seek competitive bids, and price competition between suppliers is strong. Households and small commercial consumers, on the other hand, are much less aware of costs. Furnace oil is delivered to households at prices varying over a narrow range (unlike gasoline prices) with a variety of service and insurance plans to cover burner service, reconditioning and replacements parts. The prices for these options vary somewhat by company. The smaller consumers have an imprecise notion of the relative costs of different energy forms or types of burning equipment, and use such small quantities that the potential price saving from comparison shopping often appears to be not worth the time. Moreover, small consumers are more attracted by the security and convenience of a long-term relationship with a single fuel oil distributor.

6.8 Accordingly, in the household market, there is little potential reward to a refiner or distributor from vigorous price competition. The home heating fuel market is the one sector of the petroleum products market in Ontario that exhibits some signs of retail price leadership. Retail sales typically take place at posted prices, and to date, the industry has been able to recover a higher portion of government-authorized price increases based on cost changes than has been the case in the retail gasoline market. Consequently, heating oil retail sales are currently contributing relatively more to revenue than gasoline. Excessively high retail prices are prevented, however, because above-normal returns would be a sufficient incentive for independent distributors to seek market share gains with price cuts.

6.9 In the wholesale market, prices have historically been limited by offshore product. With Ontario refiners essentially operating to balance gasoline demand, the supply of heating fuels is not equal to the market demand, and substantial quantities must be brought into the Province. In the past, independents imported product from Caribbean and European sources at prices significantly below those they could obtain from Ontario refiners. The current federal oil import compensation program has effectively removed this source of competition. In April 1976, this program compensated importers for the difference between the world and domestic prices of crude oil at $4.55 per barrel, while paying compensation of only $3.05 per barrel of imported heating oil. The price differential establishes a barrier to any imported product that is selling for less than $1.75 below world prices (this figure includes some estimate of the cost of transporting costs of imported product into Ontario from Eastern Canada). Today, the Ontario market for furnace oil is virtually insulated from competitive world prices. As the price of Canadian crude oil moves to world levels and the federal compensation program is phased out, offshore supply should become

available to the Ontario home heating market, and competitive world prices a factor in wholesale pricing. Moreover, the substantial increases in refining capacity by Texaco and Petrosar will further stimulate competition in the furnace fuel market.

* * * * *

6.10 In industrial markets, bidding procedures ensure competitive prices, but the home-owner market appears less price-competitive, as security and convenience are important sales features. Accordingly, the industry has been able to fully realize authorized price increases in the latter market.

CHAPTER 7

INDUSTRIAL/COMMERCIAL PRODUCTS

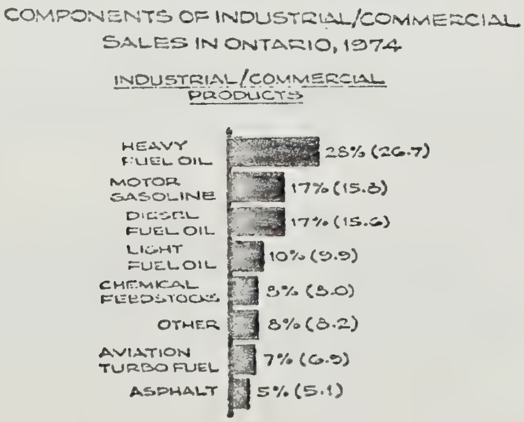
7.1 Competition in selected industrial/commercial product markets, a topic that did not appear controversial and as to which no substantial submissions in evidence were either offered or sought, was made the subject of a staff study. Information was gathered through questionnaires to suppliers and interviews with corporate consumers. As is to be expected where professional purchasing practices are followed, the results of this study confirmed that this product market segment is generally competitive. The findings of the staff study are presented in this chapter in the following sections:

(a) competition;

(b) selected product markets.

COMPETITION

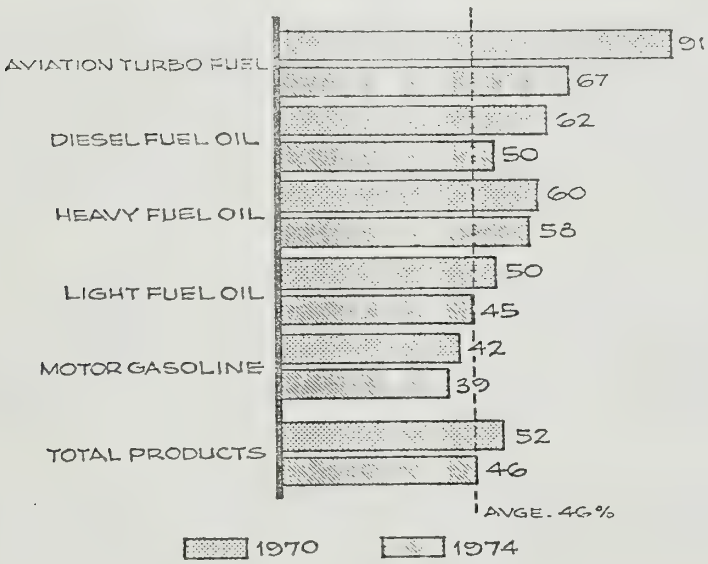
7.2 The industrial/commercial markets account for about 52 percent of the total Ontario market for petroleum products by volume. The seven products that make up 92 percent of the commercial/industrial markets are heavy fuel oil, motor gasoline, diesel fuel oil, light fuel oil, chemical feedstocks, aviation turbo fuel and asphalt. The first three account for more than 50 percent of the total, or more than 58 million barrels in 1974.



SOURCE - STATISTICS CANADA, CAT. NO. 45-004.

7.3 Market share concentration is greater in the industrial/commercial market in Ontario than in the retail gasoline market. In each product segment, two companies tend to dominate, but the leaders differ by product. The highest degree of concentration exists in the market for aviation turbo fuel, where the two leading companies controlled two-thirds of the market in 1974. This situation results in part from decisions by two of the seven integrated companies operating in Ontario not to produce this product, but it also reflects an historical pattern of supply. Market share concentration is also relatively high for heavy fuel oil; for some companies strive to minimize the output of this product in Ontario owing to the low financial realizations possible from residual products. In all major product areas, the markets were more evenly balanced in 1974 than in 1970.

PERCENT ONTARIO MARKET SHARE BY VOLUME
HELD BY TOP 2 COMPANIES*



* NOT NECESSARILY SAME 2 IN 1970 AND 1974
SOURCE - INDUSTRY DATA FROM COMMISSION QUESTIONNAIRE

7.4 Market shares for products essentially in the industrial/commercial market generally fluctuate more than those for the retail-oriented motor gasoline market as major customers can generate large swings in volume.

SELECTED PRODUCT MARKETS

7.5 This section looks at the marketing in Ontario of selected industrial/commercial products: heavy fuel oil, diesel fuel oil and aviation turbo fuel.

7.6 Heavy fuel oil is the largest selling industrial/commercial product by volume in Ontario. At 26.7 million barrels in 1974, it accounted for 28 percent of the industrial/commercial markets. The major users of this product are Ontario Hydro and the primary manufacturing industries such as steel, pulp and paper, and cement. However, heavy fuel oil supplies a minor part of Ontario industry's total energy requirements and is used on a selective basis. For example, Ontario Hydro's heavy fuel oil costs exceed those of the BTU equivalent in coal by 22 percent. Hydro uses the fuel only for peak loads, as its supply is more flexible than that for any other energy source. Also, natural gas and light fuel oils have become substitutes in recent years for heavy fuel oils in several industries such as steel and pulp and paper.

7.7 The price of heavy fuel oil historically is at or below that for crude oil. Prices now range between $7.50 to $9.50 per barrel for large orders, depending on location. Spot prices can sometimes be lower. Typically, the spread between the high and low bidders on a contract is in the order of 70¢ per barrel, and contracts are generally written for a one-year period with a 30-day cancellation clause.

7.8 Ontario refineries yield low proportions of heavy fuel oil, about 15 percent, but refineries in Quebec and the Caribbean provide competition in marketing this product. Moreover, several independent wholesalers compete with the majors, and at least one specializes in marketing heavy fuel oil to the steel industry.

7.9 Diesel fuel oil ranks behind heavy fuel oil and commercial gasoline as the third largest-selling industrial/commercial product. At 15.6 million barrels, it accounted for 17 percent of these markets in 1974. Major users of diesel fuel oil include the railways, which consume about 25 percent of total output, and trucking and marine transportation fleets.

7.10 Contracts are generally written for a one-year period with 30-day renegotiation clauses, and large-volume buyers are today paying approximately 36¢ per gallon. Competition for large-volume sales of diesel fuel is active, and it is not uncommon for a buyer to receive bids from all major refineries and independents, with spreads up to 1¢ per gallon.

7.11 At 6.9 million barrels, aviation turbo fuel accounted for 7 percent of the industrial/commercial markets in Ontario in 1974. The largest single buyer of this product is Air Canada, which purchases close to 50 percent of Ontario's output. As a result of price increases over the past three years, fuel costs now represent approximately 25 percent of Air Canada's total operating costs. Every incentive exists to purchase the product at the lowest cost possible.

7.12 Price is the dominant competitive factor in the sale of the fuel, as product specifications are standard and no delivery advantages exist. An airline such as Air Canada will contract with a supplier for a period of one to five years. At any time, the number of suppliers could be one or more depending on the availability of product and the prices offered.

7.13 Only five major refiners produce aviation turbo fuel, and the supply has traditionally been tight. However, supply will increase over the next two years as the airlines switch to greater use of kerosene, and new refineries begin operation.

7.14 These markets appear to be competitive and functioning with at least reasonable efficiency.